VZCZCXRO4655
RR RUEHCD RUEHHO RUEHNG RUEHRS
DE RUEHME #0348/01 0332301
ZNR UUUUU ZZH
R 022300Z FEB 10
FM AMEMBASSY MEXICO
TO RHEBAAA/DEPT OF ENERGY WASHINGTON DC
RHEHAAA/NATIONAL SECURITY COUNCIL WASHINGTON DC
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUEHC/DEPT OF LABOR WASHINGTON DC
RUEHC/SECSTATE WASHDC 0309
RUEHC/USAID WASHDC 0005
INFO ALL US CONSULATES IN MEXICO COLLECTIVE

UNCLAS SECTION 01 OF 02 MEXICO 000348

SENSITIVE
SIPDIS
STATE FOR WHA/MEX. WHA/EPSC, EEB
NSC FOR RESTREPO, FROMAN, LIPTON
USDOC FOR 4320/ITA/MAC/WH/ONAFTA/GWORD
TREASURY FOR NANCY LEE, IA
ENERGY FOR WARD, LOCKWOOD AND DAVIS

E.O. 12958: N/A
TAGS: ECON EFIN ETRD ENRG ELTN EAIR PGOV SENV MX
SUBJECT: NEW CENTRAL BANK GOVERNOR ON THE ECONOMY AND MONETARY POLICY

¶1. Summary. In his first speech as central bank (BOM) governor on January 27, Agustin Carstens addressed the state of the global economy and its impact on Mexico's recovery. He also discussed the BOM's monetary policy and projections for inflation in 2010 and
¶2011. Carstens said the temporary pass-through impact of gasoline price increases and higher taxes should peak in April or May, after which policymakers will be able to better gauge whether the price increases are having second-round effects. Demand-side inflationary pressures may not appear until next year, he said, but will be closely monitored. He also announced that the BOM's Foreign Exchange Commission is thinking about implementing a foreign reserves accumulation program in order to gradually withdraw from the IMF's flexible credit line. While Carstens' plan to boost reserves through dollar purchases may cause short-term market concerns, over the longer term it will bolster confidence following recent sovereign ratings downgrades. End Summary.

The Global Economy

¶2. Carstens said that there are signs of a global economic recovery, though it is still vulnerable given the risks that financial shocks could pose. Financial markets are improving, but some institutions need to absorb significant losses. There is currently moderate inflation in the world. The IMF revised its world economic growth projections for 2010 to 3.9%. Emerging economies will be the main drivers for this growth. To offset the impact of the crisis, countries have accommodated their monetary policies to lower their interest rates. Some countries have begun withdrawing their fiscal stimulus.

¶3. The U.S. economy has also registered positive economic figures, particularly its industrial output, which is strongly correlated with the Mexican economy. U.S. GDP will likely grow between 2.5 and 3% in 2010. Notwithstanding, unemployment in the U.S., more restrictive credit conditions, and high savings or payment of debts will affect consumption. There is concern and uncertainty about what the impact will be on the global economy of removing the fiscal stimulus, as well as the way industrial countries will address their large fiscal deficit. Lower interest rates in industrial countries have triggered carry-trade to emerging economies, including Mexico. Carstens noted how countries remove

and modify fiscal stimulus and monetary policies, and these capital flows' reaction could later cause volatility.

Mexico's Economic Recovery

¶4. The recovery in the U.S. has had a positive impact on Mexico. Mexico's manufacturing exports have begun to grow, and the recovery has been passed to the services sector, which was also hit by the crisis and the H1N1 flu outbreak. Financial conditions are improving and credit to construction, housing, consumption, and businesses is slowly growing. Mexico has had a relatively vigorous economic recovery in 3Q09 and 4Q09, growing 3% and 1.2% quarter-on-quarter. Retail sales and industrial output are also growing. Public investment, thanks to the GOM's countercyclical measures, has risen, but private investment has yet to recover.

¶5. After having fallen 7% in 2009, Banxico expects GDP to grow between 3.2% and 4.2% in 2010 from its previous projection of 2.5-3.5%. (Note: The IMF also recently boosted Mexico's 2010 GDP growth outlook to 4.0% from 3.3% previously. End Note.) Formal employment is recovering and by the end of 2010 between 500,000 and 600,000 formal jobs will have been created (from the former

projection of 350,000-450,000). The current account deficit will be moderate, reaching 1.2% of GDP in 2010.

Inflation Forecast

¶6. The new tax measures and the elimination of fuel subsidies are expected to have a one-time effect on inflation during 2010. However, the negative impact of these factors will likely dilute towards the end of 2010 and beginning of 2011, so that the BOM achieves its 3% inflation target by year-end 2011. Year-end inflation for 2010 was left unchanged at 4.25%-4.75%. Medium and long-term inflation expectations are well anchored, but the BOM will monitor them closely to see that there isn't a pass-thru to consumer prices, or that businesses do not transfer costs -- for those products or services not affected by the tax measures or higher fuel prices -- to consumers. The BOM will also be vigilant that there is not a change in the current capital inflows that could increase the volatility of the exchange rate.

Gradual Exit from IMF Credit Line

¶7. Finally, Carstens announced that the central bank will soon announce a mechanism to accumulate foreign reserves to withdraw gradually from the IMF's flexible credit line (US$ 47 billion). Carstens stated that a specific exchange rate would not be targeted, but rather a specific minimum or maximum cap in reserves. Mexico is seeking to increase the level of international reserves as shield against an eventual capital outflow from Mexico once other economies begin to withdraw their monetary and fiscal stimulus. The BOM and Hacienda are currently discussing the optimum level of reserves and the best mechanism to accumulate them.

Comment

¶8. Carstens' plan to boost reserves through dollar purchases may cause short-term market concerns, largely because it calls into question expectations of a strong peso rally this year. However, over the longer term it will bolster confidence following recent sovereign ratings downgrades. Even though in absolute terms the level of foreign reserves Mexico holds is quite similar compared to other BBB-rated countries, its ratio to GDP is not large. Mexico's near-record US$91.2 billion in currency reserves is equal to about 8.3% of GDP compared with 15% for Brazil and 24% in Peru. On the other hand, even though it was thought that holding reserves was really expensive before the crisis, the financial turmoil proved that it was not enough. An abrupt strengthening of the peso-probably boosted by truck loads of foreign investment-could trigger the BOM to implement a U.S. dollar purchase preannounce mechanism as the ones that were in place in the past, and this could limit peso appreciation vis-a-vis the US dollar in the medium term. End Comment.
PASCUAL